THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 303 **July 1998**

At the Brink

> **"The current economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American economy."**
>
> **—Alan Greenspan, June 10, 1998**
> **Testimony Before the Joint Economic Committee, U.S. Congress**

Chasing stock prices higher, investors are ignoring two major escalating risks. The one is the developing depression in Asia, which is growing wider and deeper every day. The other big shadow over global stock markets is a dramatic downshift in US corporate earnings, putting valuations under increasing scrutiny. Rightly or wrongly, Wall Street is the pacesetter for the rest of the world. Some of this is really becoming reminiscent of 1929.

True, this global financial bull market is primarily propelled by unbridled availability of liquidity and leverage. Yet it always needs in addition some kind of rationale forever higher market valuations. Prevailing bullish perception in the stock markets has it that the imperative of raising shareholder value, imposed on corporate management, has moved corporate earnings generally onto a higher growth tack, first in the United States and increasingly also in Europe, justifying thus the record-high stock valuations.

As we explained in the last letter, all this is complete nonsense. Harping in this letter again on the profit theme, we disclose further shocking facts. Actually, the sharp descent in US profit growth started as early as in the first quarter of 1995 which, paradoxically, was the beginning of the big bull market. Over the three years since then, US profits after tax have risen overall by a mere 18 percent, or 6 percent annually. Not only have the productivity and profit miracles, of which Wall Street raves, never happened. Worse, the profit performance in this cycle is the worst ever, and this despite the strong economic growth.

COMPLACENCY REIGNS AMONG GLOBAL POWERS

Over the last weeks, the leading three official world economic and financial institutions — International Monetary Fund (IMF), Organization for Economic Co-operation and Development (OECD) and Bank for International Settlement (BIS) — have successively published their half-yearly reports on the global situation. Frankly speaking, we found the first two rather complacent, despite a belated admittance that the likely effects of the Asian crisis are more severe than they initially appeared. Still, the IMF adds reassuringly to expect no more than a relatively mild global slowdown, citing as important reasons the "solid prospective growth of domestic demand in most industrial countries and the limited spillover effects of the Asian crisis in other regions." In short, complacency continues to reign supreme.

Rather different in tone is the BIS report, the top organization of central banks domiciled in Basle, Switzerland. Right in the first paragraph, it characterizes and details the causes and symptoms of the Asian crisis, expressing in few words, what too many experts still fail to see or to understand:

"Although some difficulties had been foreseen, the suddenness with which the crisis began, the relentless process of contagion across countries and the magnitude of the collapse in exchange rates and asset prices were all unexpected and unprecedented in recent times. And the shock was all the greater in view of the emerging consensus that Asia was the model for the future. Nor is it totally clear that the worst is over. While financial markets have stabilized somewhat, the full impact on domestic companies and the institutions that have lent to them remains to be seen, as do the full social costs."

"The domestic sources of the crisis are, with hindsight, all too obvious. They might and should have been avoided. Excessive credit growth and ***associated over-expansion of the capital stock****, inadequately supervised banking systems, asset price bubbles and excessively rigid exchange rate regimes played roles of varying importance in all of the countries affected. Nevertheless, it would be a mistake to conclude that all the difficulties could have been easily avoided if only domestic policies had been somehow better. These events have occurred against a backdrop of* ***international macroeconomic imbalances*** *which contributed materially to developments in Asia and may yet have further manifestations."*

The general failure to foresee the severity of the Asian crisis has two main reasons. First, lack of appreciation both of the magnitude of the existing "bubble" excesses and the massive misallocation of resources they entailed. And second, lack of appreciation of the fact that that the monetary policy of these countries is hijacked by their heavy dependence on foreign capital inflows. In 1996, private capital inflows to South Korea, Indonesia, Malaysia, Thailand and the Philippines totaled $93 billion, up from $41 billion 1997. In 1997, that abruptly changed to an outflow of $12 billion.

SHORT-TERM ASIAN INTEREST RATES	
China	8.1
Indonesia	35.5
Malaysia	11.0
Philippines	14.4
South Korea	19.9
Thailand	22.5

Source: The Economist

One consideration, in particular, has induced us to fear the worst for these countries. That is a comparison with the economic development in Japan since the bursting of the bubble in 1990. Apparently, the financial and economic dislocations resulting from excessive credit growth are very much the same in both areas. In the Pacific Rim countries, just as in Japan, the credit excesses went overwhelmingly into an extraordinary capital spending boom, both in property and industrial capacity, leaving behind a ravaged banking system and overindebted corporations. But there is one crucial, ominous difference. With its big, chronic trade surplus, Japan was and is at liberty to slash its interest rate almost to zero. With their weak balances of payments, these countries are stuck with high interest rates. Once a crisis hits, the downside of unfettered global capital mobility hits back with a vengeance.

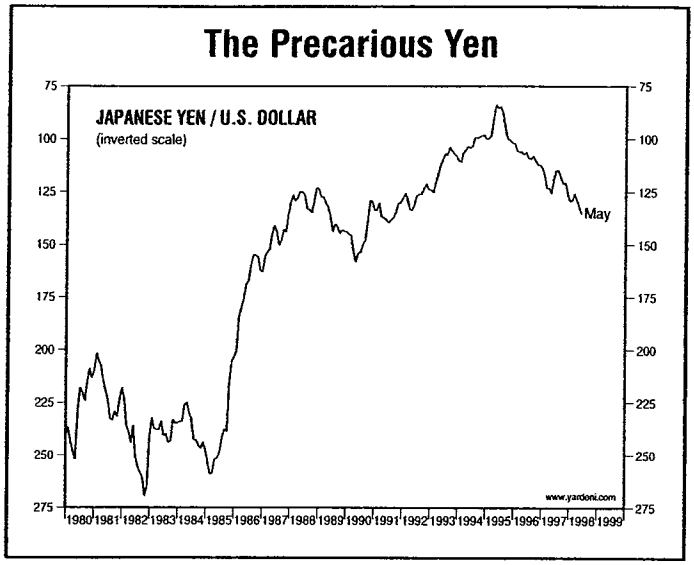
JAPAN'S MUDDLE

September next, it will be fully three years that Japan's economy and financial system are living with a discount rate of 0.5 percent. These rock-bottom interest rates were complemented by a sequence of huge fiscal packages catapulting public indebtedness since 1991 from barely 60 percent to presently 96 percent of GDP. While such packages became bigger and bigger, the lifts they gave the economy kept getting briefer and briefer. After so many fiscal packages, self-sustaining economic growth is more elusive than ever. Rather, deepening recession is looming. In the first quarter, Japan's GDP has contracted 1.3 percent, after 0.4 percent in the fourth quarter (not annualized). The figures mean that GDP has shrunk 0.7 percent for the entire fiscal year that ended this past March, the first time in 23 years that it has fallen over the space of a whole year.

It was this news that sent the yen skidding. With his flippant remark toward Japan "You broke it, you fix it", Robert Rubin, US Treasury secretary, certainly helped to fan the panic that instantly gripped currency and

stock markets around the world. It was an unbelievably stupid remark, virtually suggesting that the US was indifferent to the yen's level. The change of heart in Washington, prompting intervention to support the yen, is a measure of the extent to which the US authorities have become alarmed in recent days by the violence of stock market reactions not only in Asia but hitting Wall Street and Europe's stock markets as well. For the first time, apparently, the Asian crisis was taken seriously as a threat to global economic and financial stability.

On the other hand, it should not be overlooked that Wall Street neither wants a strong yen. Too much yen strength would jeopardize the existing huge leverage in global financial markets, built to a large extent on floods of extremely cheap money from a weak yen. A rising yen would disrupt these flows, even with interest rates unchanged.



Is this the end of Japan's economic and financial crisis and the bottom for the yen? The general hopeful answer is that everything now depends on whether or not Japan will oblige American requests to restructure its ailing banking system and accelerate efforts to boost the economy with another big dose of deficit spending.

Americans, in particular, hold the view that the persistent sluggishness of Japan's economy has one main reason, and that is the economic incompetence of Tokyo's bureaucrats, in short, a paralyzed Japanese government. Implicit to this mainly American thinking is the view that that there could never be a serious economic downturn as long as the central bank of the country concerned turns on the money and credit tap.

MISGUIDED AMERICAN ADVICE

Obviously guided and elated by their rosy perception of America's own recent experience, Mr. Clinton and his aids are calling for a credible program to clean up Japan's banking system and reflate its sagging economy, along with more deregulation and permanent tax cuts to encourage Japanese consumers to a spending spree.

Unfortunately, as we shall immediately explain, America's recent policy and growth experience is literally worthless for Japan. The reasons for this are fundamentally different underlying domestic demand structures. In actual fact, the situation today in Japan resembles that in the United States during the 1930s: a highly productive industrial society that managed to stumble over the bursting of an asset bubble being unable to get itself restarted despite near-zero interest rates and intermittent efforts to pump-prime the economy with massive deficit spending.

To lubricate economic growth, it essentially needs domestic borrowers who convert available savings from current income into spending and new income growth. In the United States, this spending gap caused by savings from current income is trifling, accounting for less than 2 percent of GDP. In gross contradiction to all the talk about the success of supply-side policies, US economic growth has since the 1980's been overwhelmingly propelled by an unprecedented consumer borrowing and spending binge – at the expense of savings. But what has worked in the United States, does not necessarily work in Japan's totally different

economic culture. American experience and advice on this line is misguided.

The thing to see in the first place is the circumstance that Japan's economy is a high-savings, high-investment economy. Both the economy and its financial system are traditionally geared to transform a large supply of domestic current savings, accounting for 9-10 percent of GDP, into domestic investment spending and foreign lending financing a large, chronic export surplus. As a consequence, growth in consumer spending depends heavily on income creation through rising investment spending and exports.

Japan's root problem today is that in the aftermath of the bursting of the bubble the corporate investment boom and the associated income creation have collapsed. Instead, the business sector is now running a growing financial surplus, adding to the huge savings surplus of the private household sector. It's typically American to take it for granted that Japanese consumers will spend or even overspend any income gains from tax cuts. Apparently, it has yet to be realized that with the rock-bottom interest rates in Japan, it needs even more savings to take care of old age.

The successive fiscal packages from 1992 to 1997 have intermittently absorbed some of the excess savings causing temporary economic rebounds, but package after package has failed to have any effect in the way of self-sustained, cumulative economic growth. Neglect of the banking crisis was certainly a grave blunder of the Japanese authorities, yet a more thorough analysis of the situation in Japan strongly suggests that demand for credit is lacking just as much as the potential supply of credit. Restoration of a well-functioning banking system is a necessary but not a sufficient precondition of reviving Japan's economy.

As for the new weakness of the yen, the irony is that it unquestionably has been aggravated by Washinton's insistence that Tokyo had to deregulate its financial system as part of its Big Bang. Given the existing enormous yield differentials between yen assets and dollar assets, it was an outright invitation for currency troubles, as currency movements are nowadays driven by capital flows. But isn't it that financial America wants above all maximum capital inflows from Japan to buoy its capital markets?

It is our view that the Japanese economic predicament has deeper reasons than just incompetence of the political leaders. Japan's investment ratio is still the highest in the world, but it is insufficient to absorb the extremely high supply of domestic savings. This is putting the whole economy into a vicious circle of self-deflation.

CORRECTION OR ONSET OF A BEAR MARKET?

Looking at skidding stock prices around the world, various questions come to mind: Is this just a technical correction or the onset of a sustained global bear market? What is specifically ailing the US stock market, considering that Mr. Greenspan in his recent Congressional testimony virtually raved about "this unprecedented period of prosperity" in America?

Nevertheless, Wall Street is obviously leading the global downturn in stock markets. European stocks have so far this year been the star performers, vastly outpacing US stocks. Hype is drawn from the belief that European corporations will be energized by growing competitive pressure from the transition to a new common currency and the spreading adoption of the Wall Street imperative to boost profits and shareholder value. Given our more than skeptical view about the economic merits of this mode, we are essentially unimpressed by this argument. While the profit outlook for corporate Europe remains for the time being positive, given high productivity gains and slightly accelerating economic growth, European stocks still have no chance against the

double-whammy of a developing bear market on Wall Street and a falling yen. Wall Street is the global pace-setter.

During this prolonged, global bull run in stocks, there have been two, or three minor corrections. The right thing to do was to buy on the dip. What is different this time? We would say, the world economic situation is at a critical juncture: Japan, after all, is in recession and Southeast Asia on the verge of depression. Our main contention with the consensus view at present, however, concerns the US economy. Yes, it has impressive momentum, but behind this display of extraordinary strength there lurk, in our view, enormous imbalances.

What we see on Wall Street is the unraveling of the boastful claim that the American model of shareholder-value capitalism has created a completely New Economy which is able to deliver strong growth with low inflation but high rates of return on capital in permanence. As we have started to explain in the last letter and continue to explain in this one, **"Shareholder-value capitalism" is degenerate capitalism**, implicitly leading in the longer run to lower economic growth and lower overall profits. The strong growth that we see today comes largely from bubble effects.

Update on Recommendations

It's time to short **Starwood Lodging (NYSE:HOT).** On June 24, Starwood Lodging lost its effort to change legislation that aims to end tax breaks for paired-share REITs. Congress is expected to pass a bill in the next few weeks to take away Starwood's unfair tax benefits. This is exactly what we predicted two months ago. When Congress takes away Starwood's unfair advantage, it will deliver a crushing blow to the company. We expect to see the shares fall almost 30 percent in the near future, for solid gains in our short position.

On another note, shares of **Micron Technology (NYSE: MU)** have been rallying. The shares have now risen from a recent low near $20 to $26, which is painful for our short position. To make money on shorting stocks in the long term, one must be willing to cut losses. Though we can't fathom why this chip-maker trades at a P/E of 40 times 8/99 earnings, we have to cut our losses at this point on Micron. Close your short position now.

Our favorite economists of the Austrian school, Mises and Hayek, would argue that this brand of American capitalism is in reality anti-capitalistic because it fosters shortcuts to profit growth — such as acquisitions, mergers, restructuring, downsizing, and so on — at the expense of long-term investment **which tends to reduce profits in the short run.** They are no substitutes for new investment and new production. The essence of capitalism, really, is that corporations generate profit growth through rising capital accumulation. As long as that happens, as it did in the past, profit growth takes care of itself. As we have tried to explain in the last letter, the shareholder-value mode of capitalism rather tends to diminish profits in the long run by imposing a bias against long-term investment.

Back to the query, what is roiling Wall Street? The consensus sees nothing but a temporary spillover from the Asian crisis. No doubt, it plays an important role, though this explanation is difficult to reconcile with the stream of comforting contrary declarations that this crisis has only minimal negative impact on the economies of America and Europe. At the very least, it proves a high vulnerability of global stock markets in the first place.

But we think there is more than just the Asian crisis behind this sudden soggy performance of US stocks in recent months. The true Damocles sword hanging over them is the dismal development of corporate profits over the past three years and the overwhelming probability — in our view — that it is sure to worsen. Once this recognition will sink in, it will finally devastate the "shareholder-value" mythology, essentially with disastrous consequences in particular for the US stock market.

(continued on page 8)

The Implosion of Global Financial Markets

IN THE SAVAGE DEFLATION AHEAD, BONDS ARE THE PLACE TO BE

Not since August of 1995 had the U.S. intervened in the foreign exchange markets and it had been more than six years since the Fed sold dollars to purchase yen. And following comments just days before where Treasury Secretary Rubin questioned the effectiveness of currency interventions the markets, not surprisingly, were caught flatfooted by Rubin's decision to sell dollars to buy yen. With stunning alacrity, the Dow gained almost 230 points, southeast Asian currencies and stocks surged as much as 10%, Latin American equities rallied strongly, and even depressed commodities showed signs of life as the Goldman Sachs Commodity Index surged more than two percent, its best showing in months.

Bullish spin quickly propogated the theory that the U.S. move was signaling an important policy shift - the end of Asian crisis "benign neglect" - in response to Japanese promises to at last act decisively to reflate its economy and resolve its financial difficulties. A more somber analysis saw the U.S. forced to move by increasingly nervous Chinese authorities threatening a destabilizing currency devaluation in China. In our view, Rubin was reluctantly forced to move by a confluence of factors easily simplified: Asian turmoil threatened to escalate into a global financial and economic crisis both quickly spiraling out of control and getting much "too close to home" as Latin American currencies and financial markets came under intense pressure and the Dow was hit for a one day loss of more than 200 points.

Incredibly, the developing Asian crisis has for months been belittled if not virtually hailed as an incident that will primarily take the edge off an overheating U.S. economy, forestalling thus a rate hike by the Fed. Unfortunately, the money and credit excesses so responsible for the Asian collapse today permeate the global financial system and are, indeed, everywhere present in the Americas. Hence, there should be little surprise that the "Asian contagion" spreads with such ease. Just as the financial collapse exposed the vulnerabilities of Asian economies, the developing international crisis is uncovering a fragile global economy.

For some time now we have repeatedly warned of the ominous ramifications of an unprecedented global proliferation of debt. Specifically, we have questioned the flood of leveraged "hot money" and surging bank credit that have been at the heart of credit excesses throughout the emerging markets. We have always viewed this as a most global phenomena with problematic portability.

As leveraged operators suffer losses in one market, they are quickly forced to reduce exposure elsewhere, especially to the more volatile/risky emerging markets. This is particularly the case in a derivatives industry, having grown to mammoth proportions, as problems in one currency, market, country, or major financial institution/counter party, can quickly develop into a systemic risk.

Credit system implosions in Asia have hit emerging markets replete with heavily leveraged international banks and speculators leading to a painful and self-feeding liquidation throughout. And, as has been the case throughout Asia, economic turmoil quickly follows and worsens the financial crisis. As emerging markets implode, safe-haven dollar buying only exacerbates the situation as dollar strength leads to more emerging market selling and a deeper financial collapse. Importantly, the financial collapse has now so severely impaired financial systems throughout Asia it will take years to recover.

Among the more significant errors made in analyzing the global ramifications from the Asian crisis has been the almost singular focus on the immediate bilateral trade effects. With booming economies in the Americas and increasing momentum in Europe, analysts were quick to declare that the trade of both continents with Asia was too small to have any serious impact on their domestic GDP.

Given both imploding domestic demand and massive excess capacity to manufacture and export in the region, Asia's trade balance has already dramatically improved by nearly $80 billion compared to a year ago. What has not been appreciated is that the region has developed into a global manufacturing behemoth and the marginal price setter for the vast majority of manufactured goods in technology, textiles, and manufactured products generally. And now, with collapsing currencies and evaporating domestic demand, manufacturers throughout the region are positioned to flood the world with cheap products. In what appears a seminal event in global economics, Asian manufacturers will now cut prices to the point of eliminating profits for competing manufactures globally. This is potentially catastrophic for many companies and will be a growing concern for investors and bankers worldwide.

Moreover, as Asia, a key global purchaser of basic commodities, experiences a monumental collapse in wealth and domestic spending, slack demand is leading to a global collapse in commodity prices. Whether it is oil

and energy products, industrial metals, agricultural or livestock, prices are plummeting. Thus, for both raw materials and finished goods, the October financial panic in Asia was a prodigious inflection point in pricing, and hence profitability, for many producers. Indeed, it marked the onset of a problematic deflationary environment globally; a situation where collapsing prices feed a vicious spiral trapping both overindebted companies as well as economies. As the price of crude oil and other basic commodities has fallen by more than one-third, this untimely collapse is particularly problematic for vulnerable financial systems and economies in Latin America and Russia. With investors demanding higher rising risk premiums for emerging market debt, significant capital flight and central bankers forced to raise short-term interest rates to support vulnerable currencies, collapsing prices for commodities and goods exports is much a deathblow for these overindebted economies.

Looking at Latin America, we see clear signs of trouble. In Mexico, ever susceptible to capital flight and with a banking industry still much impaired from previous crisis, 40% of government revenues are derived from oil. As one-year interest rates shoot above 24%, signs of an economic downturn are unmistakable. With the government forced to cut spending twice already this year, more cuts are imminent. Not surprisingly, the peso has recently traded to all-time lows as the stock market has lost 20% of its value since May. While a booming industrial sector along the American border much distorts the perception of a strong Mexican economy, we see Mexico particularly vulnerable. While it has over the past few years been much the beneficiary of the American boom, we see its economy and frail financial system poorly positioned to weather deflationary forces, global market instabilities, and a problematic reliance on the American financial and economic boom.

In Brazil, with government fiscal deficits surpassing 6% of GDP prospects are similarly weak. For the twelve months ending May 31, Brazil's current account deficit was $32.5 billion, or 3.8% of GDP. Forced to raise rates as high as 43% late last year to stem capital flight, an economic slowdown is inevitable. Early signs are now present as appliance sales declined 8.2% in May from the previous month, or 24% below last year, as debt burdened consumers retrench. Brazil, too, has been a great beneficiary of the strong US economy and bull market. In our view, Brazil is precariously positioned to suffer mightily from economic vulnerability after a long period of economic excesses in addition to global deflationary forces and weak financial system underpinnings. Continued capital flight and a collapsing currency look unavoidable as the stock market has dropped 25% since April.

When we look at Russia, we still can not fathom why all the bullish enthusiasm over the past several years. Seeing an economy that has not grown in a decade, a government that runs massive fiscal deficits but still not able meet its obligations and a hopelessly corrupt banking system, we have long seen the bull market in Russian stocks and bonds as nothing more than crazy liquidity driven speculation. With the government debt markets dominated by leveraged speculators, it is of little surprise that meaningful selling immediately found this market illiquid. As interest rates were temporarily raised to 150% to quell capital flight and a financial market implosion, one can only fear economic, political and social ramifications for Russia. With over $30 billion of debt coming due this year, Russia joins the growing list of bailouts.

WHAT TO DO

In the conclusion of this issue, we ask you to: "Stop worrying about inflation. Asset bubbles essentially end in savage deflation. That is very bullish for bonds, but... safety lies in quality."

When the bubble bursts, there will be a flight into safe bonds. Today, the markets have deemed the U.S. and Germany as "safe." Last month, we recommended buying zero coupon German government bonds. This month, we recommend complementing that position with a position in zero coupon U.S. government bonds. The U.S. offers some of the highest real yields available in the world, with ten-year bonds yielding around 5.6 percent. The upside potential in zero coupon bonds is very significant. For example, 10-year U.S. Government zeros cost you 58 cents on the dollar. If interest rates fall to five percent in the next twelve months, that bond would be worth 65 cents on the dollar, for a low-risk double-digit percentage gain in a short amount of time. But there is nothing stopping interest rates from falling significantly below five percent. Consider Japan's experience, with current interest rates on ten-year bonds at 1.2 percent.

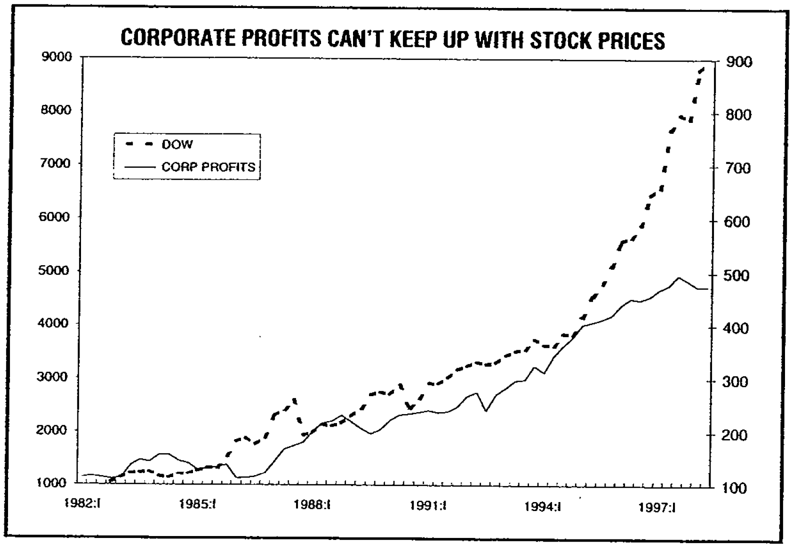
The risk in our eyes is that the U.S. market more than any other market is exposed to the yen carry trade and central bank holdings of U.S. Treasury bonds. However, when the global implosion gains strength, the flight to safety into U.S. Treasuries will drive the price of bonds higher, more than compensating you for the risk. Sell stocks and buy zeros.

For further information on German or U.S. zero-coupon bonds, you can contact Peter Schiff or Mark Anderson at Euro-Pacific Capital in Los Angeles at 800-727-7922 or 310-448-8000.

The rationale for the insane valuation of US stocks is that, by explicitly imposing increases in profits and shareholder value as absolute top priority on corporate manage-ment, Wall Street has ultimately fostered a lasting productivity and profit miracle for America.

New Economy enthusiasts don't allow hard facts to interfere with their myths. While the alleged US productivity revolution lacks so far any confirmation in the official statistics, their ready excuse is that American statistics are doing an especially bad job in capturing technological progress. In any case, so their view, what does it matter, as long as stock prices soar on the back of extraordinary growth of profits?

PROFITS, THE GREAT DENIAL



The trouble is that in the pertinent statistics the profit miracle is just as elusive as the productivity miracle. As we have elucidated in past letters, it was mainly plunging interest costs that provided a transitory supercharge to US corporate earnings. Otherwise, profit growth would have been substantially weaker than in past cycles.

There are two basic explanations for the unprecedented surge in stock prices over the last three years: liquidity-driven and earnings-driven. But the fact is that the rise in stock prices has vastly outpaced the growth in corporate earnings, not only in the United States but globally. In the US case, just 24 percent of the bull run in stock prices since end-1994 can be attributed to profit growth. All the rest came from skyrocketing valuations of corporate earnings. In this light, this bull run definitely appears liquidity-driven. Still, it is never money alone that launches and keeps a runaway bull markets in force.

By experience and logic, it always needs in addition to loose money an inspiring bull story which gives people the confidence that underlying exceptionally economic and monetary conditions — New Era — perfectly justify exceptionally high market valuations. What's more, it requires a general faith among investors, actual and potential, that this splendid economic environment and inherent superior earnings growth will last far into the future. Implicitly, time-honored benchmarks of equity valuation are ignored and discarded.

Note that the yield on the S&P 500 is now at an unprecedented low of 1.45 percent, as compared with a long-term average of 3 percent. Consider that the S&P price/earnings ratio is now a record 28.3 times earnings, as against a historical norm of 14.1. Another key measure is how many times book value is paid for a company. In normal times, good companies might trade at or slightly over book value. Consider that the S&P now sells at an average 6.04 times book value. Numerous well-known companies are selling at a whopping more than 20 times book. Not only that, huge stock buybacks at these ridiculous levels are hailed as particularly sound investment. This is the crudest form of stock price manipulation, defying any economic logic.

Having said this, we hasten to add that most investors, professionals included, simply rely on the market's momentum. Admittedly, it has worked magnificently up to the present. Given low and falling inflation rates, investors have become increasingly comfortable that there is nothing in sight to spoil the glorious party. Rising interest rates are the chief bogy they can think of, but Mr. Greenspan does his best to allay any such fears.

THE PIN THAT PRICKS THE BUBBLE

What, then, is the possible pin that will prick, first, the US stock bubble, and in its wake the global bubble if the central banks keep their money spigots wide open? In short, the bursting of the profit illusions on which this bull market has been built. As the dismal reality about profits begins to sink in, it is sure to devastate the whole new economic paradigm nonsense. That's why we keep harping on the profit theme.

The preponderant rationale for the exponential rise in US stock prices which began in early 1995, has been the perception of an underlying exponential rise in corporate efficiency and earnings. We explicitly speak of "perception" because the reality of profit growth has been extremely different during this time. Yet, in his Congressional testimony, Mr. Greenspan, conveyed a strong impression that he greatly consented with this fallacious view. Verbatim: "To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of per share earnings growth over the longer term have been undergoing continuous upward revision by security analysts since 1994. These rising expectations have, in turn, driven stock prices sharply higher...In any event, primarily because of the rise in stock prices, about $12 trillion has been added to the value of household assets since the end of 1994." In short, Mr. Greenspan fully endorses this wealth bubble the development and the thinking behind it.

As we have repeatedly expounded, this perception of extraordinary profit growth in this cycle is a pure chimera. Precisely the opposite is true. Meanwhile sharply slowing profit growth has given way to actual profit decline.

How could this false perception of legendary US profit growth ever arise? Read this from Wall Street's super bull, Abby Joseph Cohen: "The rising market has been supported by evidence that the economic expansion is long-lasting and profit-intensive rather than especially vigorous...Profits have doubled since 1991. Profits...continue pleasantly to surprise investors with their durability and quality."

Yes, US corporate earnings have between 1991-97 doubled from $240 billion to $480 billion, or by an annual average of 16.7 percent. Very impressive, isn't it? And isn't it quite reasonable to extrapolate a performance that has lasted already fully six years well into the future? According to Wall Street logic, yes. Our answer is a categorical no.

Our first contention has always been that profit growth was initially extraordinarily swelled by plummeting corporate interest costs. Once this major profit source dried up, the growth of profit rapidly decelerated. Our second contention is that this calculation which simply averages the cumulative growth of six years is grossly misleading because it relates year after

Rise in Profits and Share Prices

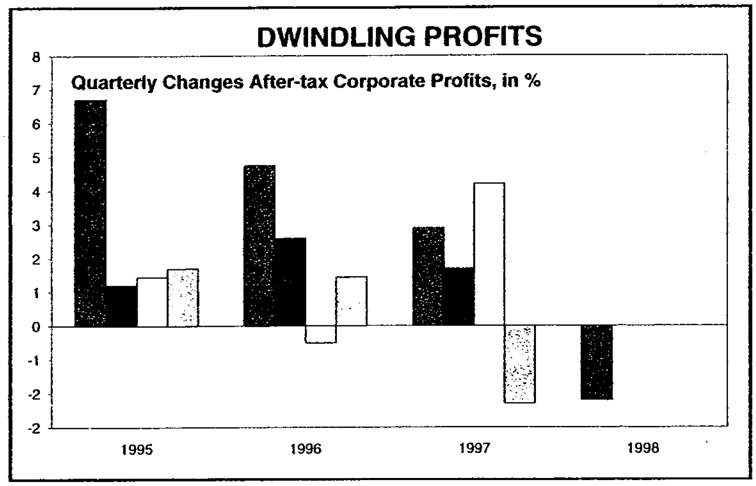
Year	Profits after tax	Profits rise in $ mln.	Profits rise in %	S&P 500 rise in %	Dow Ind. rise in %	NASDAQ rise in %
1991	240.8					
1992	263.4	22.6	9.4	4.46	4.17	15.45
1993	300.2	36.8	14.0	7.06	13.72	14.75
1994	348.5	48.3	16.1	-1.54	2.13	-3.20
1995	409.4	60.9	17.5	34.28	33.46	39.92
1996	447.6	38.2	9.3	20.07	26.01	22.71
1997	480.3	32.7	7.3	31.06	22.08	21.64
96I	438.7	37.7	9.4			
97I	467.2	28.5	6.5			
97II	475.3	25.3	5.6			
97III*)	495.2	47.7	10.7			
97IV	483.2	29.7	3.0			
98I	473.0	5.8	1.3			

*) All quarterly figures relate to figures a year ago. Source: Department of Commerce, Survey of Current Business

year to the low base of 1991 resulting thus in the high but meaningless average. It gives a totally distorted picture. To see and to understand what really happened, it requires a calculation from year to year, as in the table on the previous page.

To clarify one thing in the first place: The rapid demise of US profit growth did not start with the Asian crisis. It has been unfolding for more than three years, and it has done so against the background of accelerating real GDP growth. 1995: 2.0 percent; 1996: 2.8 percent; 1997: 3.8 percent; 1998I: 4.8 percent.

Between end-1991 and early 1995, profits after tax as reported in the national income accounts (NIPA) — surged overall 60 percent, or 20 percent annually, largely owing to a big contribution from plunging interest costs. Over the following three years, however, cumulative profit growth virtually collapsed to a mere 18 percent, or 6 percent annually. In the third quarter of last year, progressively slowing profit growth turned into actual profit decline. And most oddly, this profit squeeze is happening in a booming economy. In hindsight, it is really ironic that the upward race of stock prices started precisely, in the first quarter of 1995, when profit growth had peaked and began its steep descent.



The cumulative gain in profits after tax over the three years by a mere 18 percent compares with the following gains in stock prices during this period: Dow 135 percent, S&P 500 120 percent, NASDAQ 124 percent.

Please note, these are the profit figures published by the Commerce Department and derived from the national income accounts. They make blatant nonsense of the profit hype on Wall Street. But what makes these numbers particularly ominous is the fact that this progressive profit erosion has occurred against the background of very strong and accelerating economic growth and, second, despite the widespread and growing use of profit-enhancing accounting tricks. Yet nobody takes notice. In the scramble to pursue the new road to riches, willing blindness sets in.

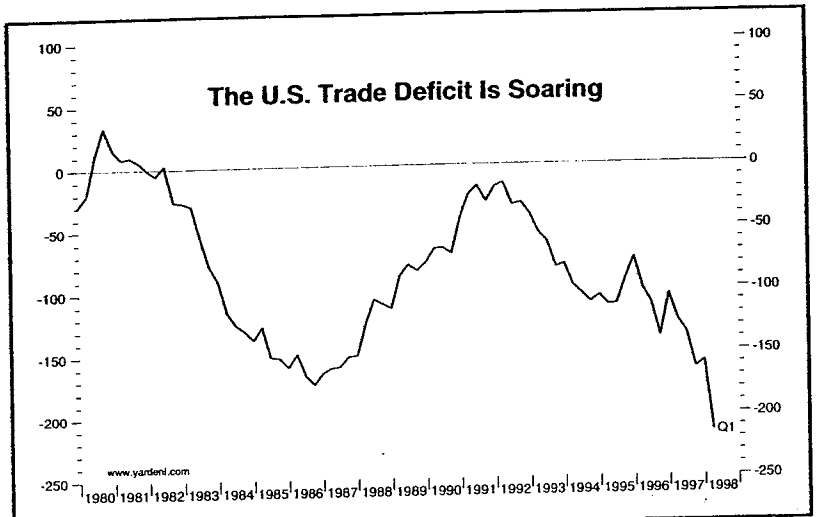
According to First Call, the well-known Boston-based earnings tracker, the consensus forecast among analysts is still for a 5.7 percent rise in S&P 500 operating earnings in the second quarter of this year. This is forecast to be followed by a 12.7 percent increase in the third quarter and a big 17.3 percent profit spurt in the fourth quarter. All these numbers apply year-over-year. Currently, as a matter of fact, reported S&P profits per share are already 1.8 percent below their level a year ago.

PROFITS IN THE WRINGER

What next for US profits? Will they sharply rebound, as Wall Street proclaims, or will they collapse, as we expect? Actually, it is hard to argue with Wall Street pundits because they habitually make forecasts without bothering about substantiation. They simply present numbers, and that is it. One has to take them or leave them.

Our conclusion of a further dramatic worsening of US business profits is by no means a random guess. It is derived from an assessment of the probable development of four aggregates that are of key significance for income and profit growth: trade balance, budget balance, investment spending, and savings. Rather sooner than later, there will be a dramatic reassessment of the expected rates of return on plant and equipment, battering both the stock market and corporate investment spending.

The biggest imminent drag on the economy and business profits is being exerted by the soaring trade deficit. This alone has the potential for a drastic profit squeeze. Second in line is further fiscal drag from the rising budget surplus. Business fixed investment will rise at a decelerating rate, while inventory investment, until recently a strongly positive influence on profits, will decline substantially.



The major imponderable for the economy and profits is consumer spending with stock market wealth effects looming large in the outlook. Biggest and most dangerous unknown in the US growth and profit equation is the potential negative impact of a declining stock market on consumer spending, and thereby on corporate earnings. It is an economy that is dependent as never before on a big stimulus to spending by a booming stock market: in short, a bubble economy. In his Congressional testimony, Mr. Greenspan, to our consternation, hailed the fact that the rise in stock prices had since the end of 1994 added $12 trillion to the value of household assets which, in turn, propelled consumer and equipment spending. This compares, by the way, with an annual US GDP of about $8 trillion.

This relationship between wealth effects and GDP is simply absurd and precisely fits the definition of a bubble economy. Above all, it seems to escape him that he himself is not master but prisoner of this asset bubble because it has become much too big to take a risk of possibly pricking it with a rate hike.

AN ECONOMY OUT OF BALANCE

In the first quarter, the US economy roared ahead at an annual rate of 4.8 percent with a GDP price deflator of 1 percent. For the notorious bulls, this was testament to the economy's extraordinary health. To us, it warns of several, big unsustainable imbalances. Total domestic purchases soared at a 7.3 percent annual rate, the fastest pace since 1984, driven by scorching growth of consumption, exploding inventories and skyrocketing business equipment. Consumption, obviously fueled by the strong stock rally in the first quarter, accounted for 3.8 percentage points of this growth. The one thing anchoring the economy was a record $ 56 billion collapse in net exports, which lopped three percentage points off demand growth. Evident "wild card" in the outlook is the continuation or cessation of the huge stock market wealth effects. A major stock market decline would most probably spell a U.S. recession.

It is our opinion, the US market has definitely topped and a severe decline lies ahead. Any recovery is only an opportunity to unload. At long last, market participants have been sensitized to the profit cataclysm. Average earnings per share for the S&P 500 are now 1.7 percent below their level a year ago. Absurdly, the Wall Street gurus stick to the forecast of an impending fabulous profit rebound in the second half of this year, though they are at an obvious loss to explain, why it should happen. On the basis of our flows-of-funds analysis, we expect further, possibly dramatic profit erosion. Plunging profits will not only stop the stock market boom but also the economy's upswing.

In actual fact, the US stock market is already a lot weaker than the popular stock indexes are telling. Under

the guise of relative strength of the Dow and the S&P 500, the great mass of stocks has been sinking. The Russell and the Value Line, the indexes of smaller stocks, have broken down. On the NYSE about 40 percent have had a fall of more than 20 percent and more than 20 percent have had a decline of more than 30 percent. In the case of NASDAQ, around 60 percent of stocks have lost more than 20 percent and around 40 percent more than 30 percent.

What will happen to the world economy, when the US economic growth turns sluggish and the dollar plunges? Please note, we ask "when" not "if". For us, it is only a question of time for this to happen. Don't count on Europe to bail out America and the rest of the world even if EU economic growth continues to recover. According to OECD forecasts, the EU trade balance is to surge further from $169 billion last year to $182 billion this year, implying that Europe remains a drag on the world economy. This surplus has doubled within three years.

CONCLUSION:

Asian financial instability and the Wall Street bubble are two potential powder kegs. If one keg explodes, so will the other, with the probable result of a global recession and global financial debacle.

A global manufacturing slowdown is becoming increasingly evident. However, it will be several months before the fallout from the Asian crisis is fully realized in the industrial countries, particularly in the still-hot U.S. economy. Global economic growth is due for a sober reassessment.

Three big unpleasant surprises are waiting for global economies and markets: first, there is no quick fix for Japan's economic and financial malaise, implying further yen weakness; second, the U.S. economy is heading for a sharp slowdown later this year; third, further U.S. profit erosion will finally prick the U.S. stock market bubble and the consumer shopping spree.

Stop worrying about inflation. Asset bubbles essentially end in savage deflation. That is very bullish for bonds, but keep in mind that bond markets, too, are overextended by highly leveraged yield-curve playing, in particular yen-carry trade. Safety lies in quality.

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